

PRUDENT PRACTICES FOR INVESTMENT FIDUCIARIES

Practice SA - 2.3

An expected, modeled return to meet investment objectives has been identified.

ERISA Requirements

Section 404(a) of ERISA imposes on fiduciaries an obligation to act prudently. Specifically, a fiduciary is required to act:

... with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. [ERISA §404(a)(1)(B)]

The fiduciary will fulfill its investment duties if it gives:

... appropriate consideration to those facts and circumstances that ... the fiduciary knows or should know are relevant to the particular investment or investment course of action involved [29 C.F.R. §2550.404a-1(b)(1)(A)]

For these purposes, “appropriate consideration” is defined in the DOL regulations to include, without limitation:

... a determination by the fiduciary that the particular investment or investment course of action is reasonably designed, as part of the portfolio ... to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return) associated with the investment or the investment course of action [29 C.F.R. §2550.404a-1(b)(2)(A)]

In addition, the fiduciary should take into consideration the following factors:

(A) The composition of the portfolio with regard to diversification;

(B) The liquidity and current return of the portfolio relative to the anticipated cash flow requirements of the plan; and

(C) The projected return of the portfolio relative to the funding objectives of the plan. [29 C.F.R. §2550.404a-1(b)(2)]

This last aspect, considering the projected return of the portfolio relative to the plan’s funding objectives, can be accomplished by the fiduciary by “modeling” the probable return a given investment strategy should produce.

Practice SA – 2.3 (continued)

[IBP] Although modeling a probable return and its associated risk for a given asset allocation strategy is difficult, most investment professionals develop expected asset class returns using a “risk premium” model. Under this model, an estimated premium for the greater risk of the particular investment is added to the risk-free rate of return on U.S. government bonds. This “risk premium” model has been recognized by the courts in several cases, as early as 1944 in *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591, 64 S.Ct. 281, 88 L.Ed. 333 (1944), and later in *Communications Satellite Corporation v. Federal Communications Commission*, 611 F.2d 883 (D.C. Cir. 1977) and *Tennessee Gas Pipeline Company v. Federal Energy Regulatory Commission*, 926 F.2d 1206 (1991). This system follows modern portfolio theory, whereby a risk premium compensates for the risk associated with a particular investment or investment class.

The concept of modeling a probable return for a given asset allocation strategy goes to the core of the role of the fiduciary in discharging his duties -

... for the exclusive purpose of providing benefits to participants and their beneficiaries.
[ERISA §404(a)(1)(A)]

UPIA and UPMIFA Requirements

The UPIA and the UPMIFA identify the standard of care, portfolio strategy, and risk and return objectives, including the obligation to identify an investment strategy. Section 2 of the UPIA provides that:

A trustee’s investment and management decisions respecting individual assets must be evaluated not in isolation, but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust. [UPIA §2(b). *See also*, UPMIFA §3(e)(2)]

The UPIA and the UPMIFA describe some of the circumstances the trustee or institutional fund should consider in investing and managing assets, including, among others, such circumstances as general economic conditions, the possible effect of inflation or deflation, the expected tax consequences of investment decisions or strategies, the expected total return from income and the appreciation of capital, and the needs for liquidity, regularity of income, and preservation or appreciation of capital. [UPIA §2(c)(1-8); UPMIFA §3(e)(1)(A)-(H)]

The direction to the trustee and institution to look at “*the expected total return from income and the appreciation of capital,*” as well as the needs of the trust or institutional fund, require that they determine the investment objectives and then develop an investment course of action reasonably designed to produce the return and liquidity needed to achieve these objectives.

MPERS Requirements

Section 8 of MPERS imposes duties on the trustee when investing and managing trust assets. Section 8(a) is similar to section 2(c) of the UPIA in its list of non-exclusive factors the trustee should consider in investing and managing the assets of a retirement system. [MPERS §8(a)(1)(A-F)] Specifically, MPERS §8(a)(1)(D) states:

In investing and managing assets of a retirement system pursuant to Section 7 [of MPERS], a trustee with authority to invest and manage assets shall consider, among other circumstances, the expected total return from income and the appreciation of capital.

Under MPERS, the trustee with investment and management authority is required to have a statement of investment objectives and policies for each retirement program, with the statement including, among other factors, the desired rate of return on assets overall and the desired rates of return and acceptable levels of risk for each asset class. [MPERS §8(b)] These rates of return are estimates and are not intended to be specific predictions of actual returns, but MPERS §8(b) mandates that the trustee, at least annually, review the statement and change or reaffirm it.

Although modeling of a probable risk/return for an asset allocation strategy is difficult, the requirement under MPERS that the investment objectives statement be reviewed each year, at a minimum, is a protective measure for ensuring that investment objectives are analyzed and modified as necessary.